

REPORT OF EXAMINATION
OF THE
FARMERS REINSURANCE COMPANY
AS OF
DECEMBER 31, 2006

Filed June 23, 2008

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Los Angeles, California
June 23, 2008

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

FARMERS REINSURANCE COMPANY

(hereinafter also referred to as the Company or Farmers Re) at its home office located at 4680 Wilshire Boulevard, Los Angeles, California 90010.

SCOPE OF EXAMINATION

The previous examination of Farmers Re was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of Farmers Re's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

This examination was conducted concurrently with examinations of Farmers Re's California affiliates, namely: Farmers Insurance Exchange, Truck Insurance Exchange, Fire Insurance Exchange, Mid-Century Insurance Company, Civic Property and Casualty Company, Exact Property and Casualty Company, and Neighborhood Spirit Property and Casualty Company.

In addition to those items specifically commented upon in this report, other phases of Farmers Re's operations were reviewed including the following areas that require no further comment: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; accounts and records; and sales and advertising.

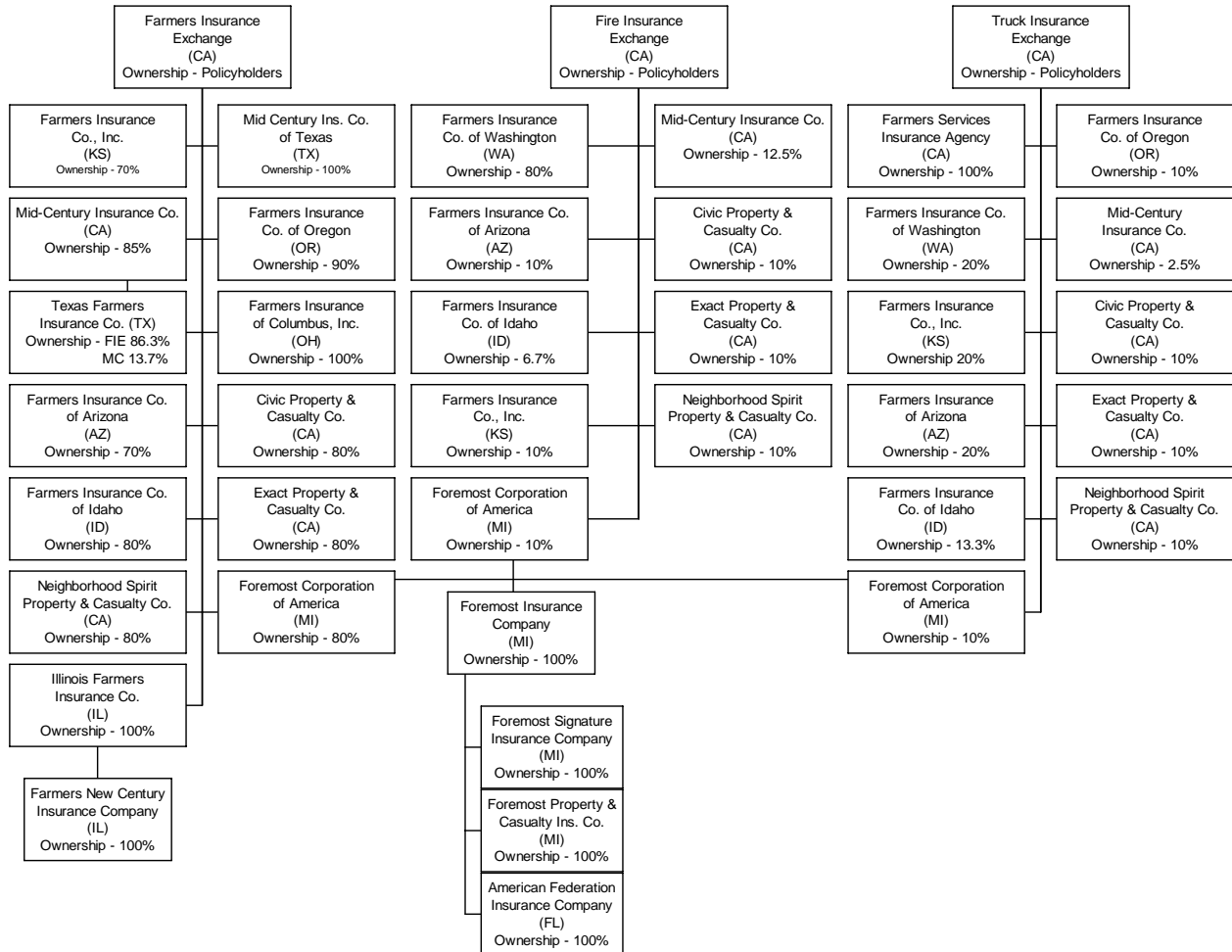
MANAGEMENT AND CONTROL

As of December 31, 2006, Farmers Re is 100% owned by Farmers Group, Inc. (FGI), a Nevada holding company. Farmers Re is a stock insurer and was included in the Combined Annual Statement with the Farmers property and casualty insurance companies, although it's affiliated with them by common control (FGI acting as the Attorney-In-Fact for the three exchanges) rather than by legal affiliation.

The following abridged organizational charts depict Farmers Re's relationship within the holding company system both as of December 31, 2006 and as of December 31, 2007:

FARMERS EXCHANGES

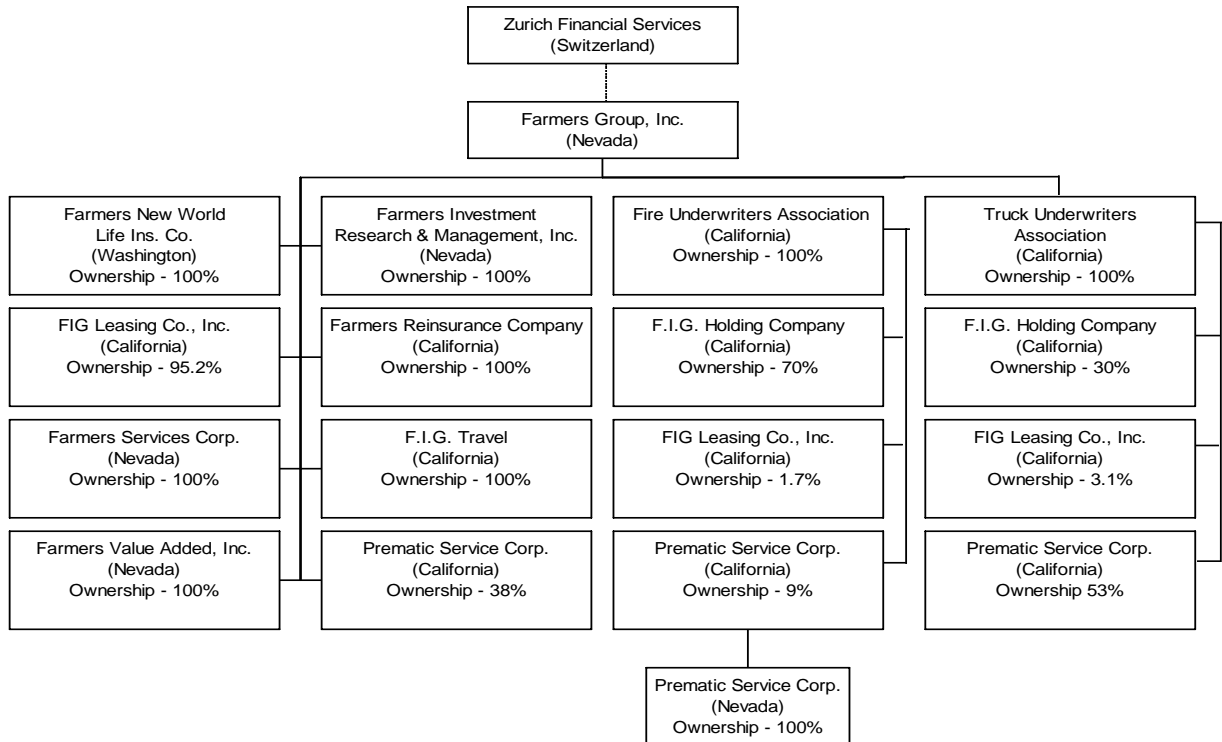
December 31, 2006



(*) all ownership is 100% unless otherwise noted.

ZURICH FINANCIAL SERVICES GROUP

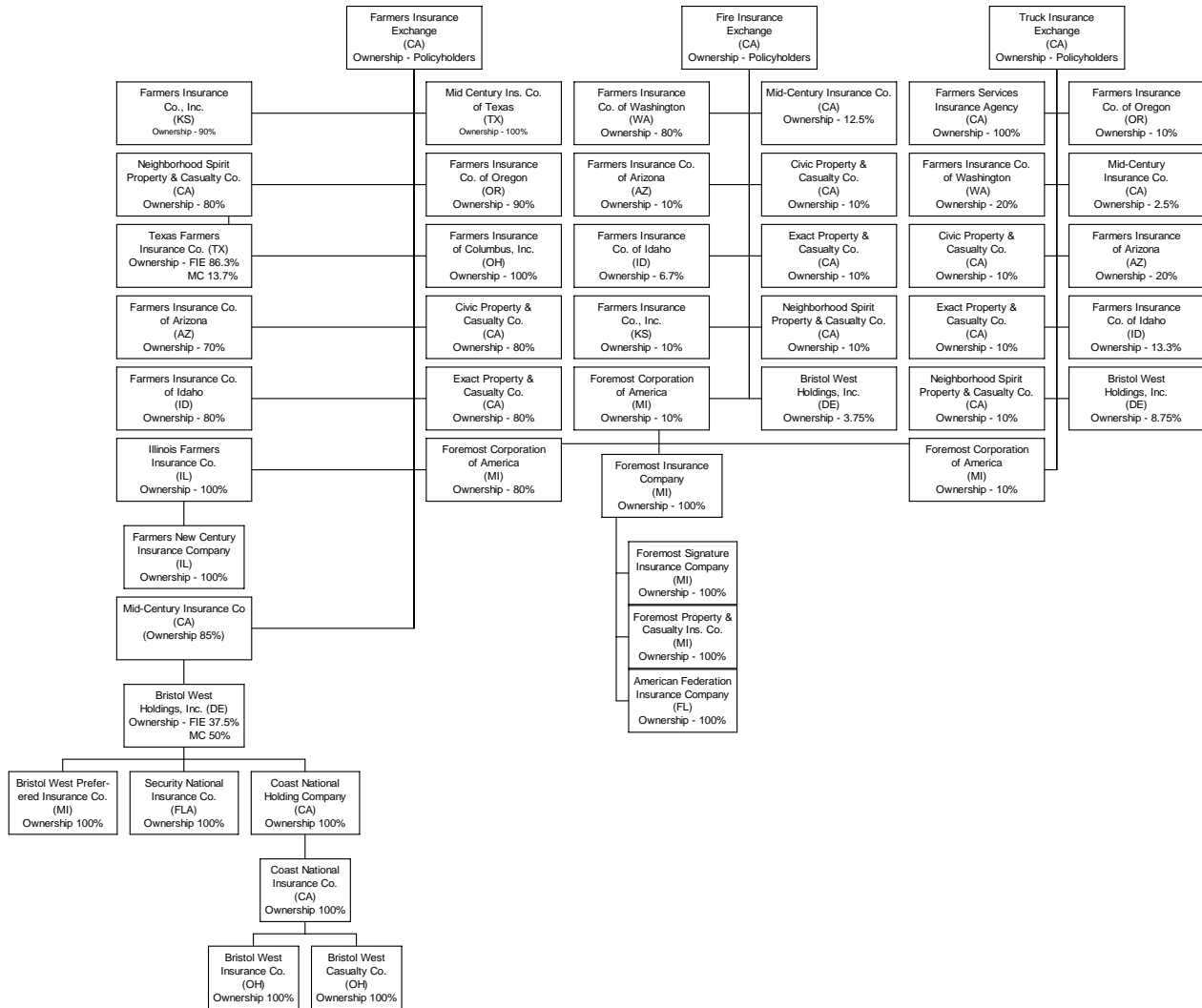
December 31, 2006



(*) all ownership is 100% unless otherwise noted.

FARMERS EXCHANGES

DECEMBER 31, 2007



(*) all ownership is 100% unless otherwise noted.

Management of Farmers Re was vested in a five-member board of directors, elected annually. A listing of the members of the board and principal officers serving on December 31, 2006, follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Paul Norman Hopkins Thousand Oaks, California	Chief Executive Officer and Member of Board of Directors Farmers Group, Inc.
Jason Lawrence Katz Los Angeles, California	Executive Vice President, General Counsel and Member of Board of Directors Farmers Group, Inc.
Keitha Tullos Schofield * Los Angeles, California	Executive Vice President and Member of Board of Directors Farmers Group, Inc.
Pierre Christophe Wauthier ** Agoura Hills, California	Executive Vice President, Chief Financial Officer and Treasurer Farmers Group, Inc.
Frank Robert Woudstra Los Angeles, California	Executive Vice President, and Member of Board of Directors Farmers Group, Inc.

* Resigned on March 16, 2007 and was not replaced.

** Resigned on October 1, 2007 and was replaced by Scott Lundquist.

Principal Officers

<u>Name</u>	<u>Title</u>
Pierre Christophe Wauthier *	President
Warren Benjamin Tucker **	Vice President and Treasurer
Doren Eugene Hohl	Secretary
Paul Norman Hopkins	Vice President
Hubert Leslie Mountz ***	Vice President

Principal Officers

<u>Name</u>	<u>Title</u>
Bryan Francis Murphy	Vice President
Ronald Gregory Myhan	Vice President
Keitha Tullos Schofield ****	Vice President
Stanley Ray Smith *****	Vice President
Frank Robert Woudstra	Vice President

- * Resigned on October 1, 2007 and was replaced by Scott Lundquist.
- ** Resigned on May 31, 2007 and was replaced by James Leslie Nutting.
- *** Resigned on February 1, 2007 and was replaced by Anthony Morris.
- **** Resigned on March 16, 2007 and was not replaced.
- ***** Resigned on July 1, 2007 and was replaced by Ronnie Coble.

Management Agreements

No written management services agreement was provided during the examination. However, Farmers Re personnel stated that an allocation of costs for specific time spent by Farmers Group, Inc. (FGI) employees on Farmers Re was periodically made. Farmers Re did not directly write any insurance business. It only assumed business on a quota share basis. As such, its operating costs were relatively immaterial. For 2004, 2005 and 2006, fees paid by Farmers Re to FGI for such services were \$203,229, \$205,390, and \$212,453, respectively.

Tax Sharing Agreement

Farmers Re's federal income tax return was consolidated with FGI and several of its subsidiaries effective February 9, 1998. The tax allocation was based on separate return calculations with current credit for net losses. It is recommended that Farmers Re submit this affiliated tax sharing agreement to the California Department of Insurance (CDI) pursuant to California Insurance Code Section 1215.5 for approval. Farmers Re's portion of the federal income taxes paid for 2004, 2005, and 2006, was \$27,500,000, \$19,600,000, and \$20,062,084, respectively.

Investment Management Agreement

Farmers Re entered into an Investment Management Agreement dated September 30, 2005, with Blackrock Financial Management, Inc. (Black Rock), New York. Black Rock is not affiliated with the Company. Under the terms of this agreement, Black Rock managed the portfolio in accordance with guidelines provided by Farmers Re.

Securities Lending Agreement

In 1999 Farmers Re, the three exchanges, and affiliates filed with the CDI a proposed securities lending agreement with an affiliate, Zurich Capital Markets Trust Company (Zurich).

In December 2001, the securities lending agent was changed from Zurich to the Bank of New York Western Trust (BNY), a non-affiliate, as Zurich had decided to exit the securities lending business. “Collateral” as defined in the securities lending agreement between BNY and the companies indicated government securities and cash. The agreement also stipulated that BNY establish a “custodial custody account” in the name of the companies for the purpose of holding collateral and approved investments pertaining to securities lending transactions. The custodian was Wall Street Portfolio Advisors, a division of BNY. The current agreement conformed to the securities lending limits specified in CDI Bulletin 82-2.

TERRITORY AND PLAN OF OPERATION

Farmers Re was licensed only in California as a multiple line property and casualty insurer. Farmers Re had not written any direct business, but had assumed multiple lines of business from affiliates. On November 16, 2004, Farmers Re received an amended Certificate of Authority from the California Department of Insurance authorizing it to write the workers’ compensation line of business.

REINSURANCE

Assumed

Farmers Re assumed quota share risks from affiliated reinsurers; Farmers Insurance Exchange (FIE), Fire Insurance Exchange, Truck Insurance Exchange, and certain of their subsidiaries as cedents in the following treaties:

Farmers Re was party to an auto physical damage (APD) 100% quota share agreement with several participants including the affiliated Zurich Insurance Company (Zurich) with an initial 65% participation and Farmers Re with a 10% participation. Several non-affiliated reinsurers assumed the remaining 25% in participation. The premium for this APD agreement since 2001 was \$2 billion annually. The APD agreement was approved by the California Department of Insurance (CDI) in 2001 for one year, with one-year extensions granted in 2002 and 2003. In 2004, the APD agreement was revised to reduce the quota share percentage to 50%, with Zurich assuming a 40% participation and Farmers Re assuming the remaining 10% participation. Effective January 1, 2006, the above amended APD agreement was replaced by a new APD 100% quota share agreement. The premium for this replacement APD agreement was \$1 billion annually with Zurich assuming an 80% participation and Farmers Re assuming a 20% participation. The CDI approved this agreement on December 28, 2005.

On December 31, 2002, Farmers Re, along with Zurich, entered into a 10% “all-lines” quota share reinsurance agreement assuming business from its property and casualty affiliates including the exchanges and their subsidiaries. This agreement was then amended, effective December 31, 2004, to increase the percentage to 12% and amended again effective December 31, 2005, to decrease the percentage down to 6% (Farmers Re a 1.2% participation and Zurich a 4.8% participation) which was the cession at the examination date. The CDI approved this 2005 amendment on December 28, 2005. Subsequently, the agreement was amended effective December 31, 2007 to decrease the percentage to 5% (Farmers Re a 1% participation and Zurich a 4% participation) and extend the duration to December 31, 2010. This latest amendment was approved by the CDI on December 28, 2007

Farmers Re's assumed premiums during 2004, 2005 and 2006, were \$625.6 million, \$430.6 million and \$348 million, respectively, from participation in the aforementioned quota share treaties.

Ceded

Farmers Re does not cede any reinsurance.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Net Admitted Assets</u>	<u>Note</u>
Bonds	\$ 935,330,145	\$ 935,330,145	
Common stocks	230,517,870	230,517,870	
Cash and short-term investments	12,615,729	12,615,729	
Aggregate write-ins for invested assets	55,451,949	55,451,949	
Investment income due and accrued	9,388,707	9,388,707	
Uncollected premiums and agents' balances in the course of collection	22,628,148	22,628,148	
Funds held by or deposited with reinsured companies	16,638,560	16,638,560	
Current federal and foreign income tax recoverable	<u>519,874</u>	<u>519,874</u>	
Total assets	<u>\$1,283,090,982</u>	<u>\$1,283,090,982</u>	
<u>Liabilities, Surplus and Other Funds</u>			
Losses		\$ 121,515,491	(1)
Reinsurance payable on paid losses and loss adjustment expenses		27,007,330	
Loss adjustment expenses		21,416,508	(1)
Net deferred tax liability		979,995	
Unearned premiums		59,307,921	
Remittances and items not allocated		63,745	
Payable to parent, subsidiaries and affiliates		108,161	
Aggregate write-ins for liabilities		<u>56,356,836</u>	
Total liabilities		286,755,987	
Common capital stock	\$ 5,000,000		
Preferred capital stock	53,800,000		
Gross paid-in and contributed surplus	575,600,000		
Unassigned funds (surplus)	<u>361,934,995</u>		
Surplus as regards policyholders		<u>996,334,995</u>	
Total liabilities, surplus and other funds		<u>\$1,283,090,982</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 345,436,809
Deductions:		
Losses incurred	\$ 191,744,248	
Loss expenses incurred	31,539,852	
Other underwriting expenses incurred	<u>108,832,280</u>	
Total underwriting deductions		<u>332,116,380</u>
Net underwriting gain		13,320,429

Investment Income

Net investment income earned	\$ 53,949,784	
Net realized capital gains	<u>1,909,739</u>	
Net investment gain		55,859,523

Other Income

Aggregate write-ins for miscellaneous income	<u>\$ 25,706</u>	
Total other income		<u>25,706</u>
Net income before federal and foreign income taxes		69,205,658
Federal and foreign income taxes incurred		<u>18,691,388</u>
Net income		<u>\$ 50,514,270</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 939,812,008
Net income	\$ 50,514,270	
Change in net unrealized capital gains	9,120,223	
Change in net deferred income tax	(2,215,006)	
Aggregate write-ins for losses in surplus	<u>(896,500)</u>	
Change in surplus as regards policyholders		<u>56,522,987</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 996,334,995</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Surplus as regards policyholders, December 31, 2003, per Examination			\$ 812,053,599
	<u>Gain in</u> <u>Surplus</u>	<u>Loss in</u> <u>Surplus</u>	
Net income	\$ 181,985,149	\$	
Change in net unrealized capital gains	12,555,092		
Change in net deferred income tax		11,031,878	
Change in nonadmitted assets	1,669,533		
Aggregate write-ins for losses in surplus	<u> </u>	<u>896,500</u>	
Totals	<u>\$ 196,209,774</u>	<u>\$ 11,928,378</u>	
Net change in surplus as regards policyholders for the examination			<u>184,281,396</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$ 996,334,995</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Farmers Re was directed by the California Department of Insurance (CDI), under California Insurance Code (CIC) Section 733(g), to retain the American Actuarial Consulting Group, LLC, (AACG) for the purpose of assisting this examination in determining the reasonableness of Farmers Re's loss and loss adjustment expense reserves. The entire loss and loss adjustment expense reserve was for reinsurance assumed from Farmers Insurance Exchange and affiliates on various lines of business, mainly private passenger auto liability and auto physical damage business. Based on the analysis by AACG and the review of their work by a Casualty Actuary from the CDI, Farmers Re's December 31, 2006 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for the purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control - Tax Sharing Agreement (Page 7): Farmers Re's federal income tax return was consolidated with Farmers Group, Inc. and several of its subsidiaries. It was recommended that Farmers Re submit the affiliated tax sharing agreement to the California Department of Insurance pursuant to California Insurance Code Section 1215.5 for approval.

Previous Report of Examination

Territory and Plan of Operation (Page 7): At December 31, 2003 Farmers Re was licensed only in the state of California as a multiple-line property and casualty insurer. Farmers Re was not licensed for workers' compensation. However, Farmers Re had assumed multiple lines of business, including workers' compensation, during the previous examination. Farmers Re received an amended Certificate of Authority effective November 16, 2004, authorizing it to write the workers' compensation line of business.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Farmers Re's officers and its parents' employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Gary W. McMurray, CFE
Examiner-In-Charge
Contract Insurance Examiner
Department of Insurance